

Fixed Income Exchange Traded Funds- An Easy and Economical Way to Diversify

Exchange Traded Funds (ETFs) are the new kid on the block relatively speaking.

The first ETF made its debut in 1993. As of December, 2006 – according to the Investment Company Institute - the ETF market is valued at \$422.48 billion... a more than 40% increase over the prior year alone.

What's all the fuss about?

ETFs blend up the utility of mutual funds and the flexibility of stocks into one easy-to-buy investment vehicle with a smorgasbord of advantages.

Like a mutual fund - an ETF represents ownership in a basket of assets such as stocks or bonds. ETFs are managed to track the performance of a securities index, be it broad-based like the S&P 500 or Dow, or based on market segments (large cap or small cap companies); market sectors (telecom, energy); foreign countries (China, Singapore); metals (gold, silver) or bonds.

Like stocks - ETFs are sold in shares instantaneously priced and traded throughout the day. There's no minimum purchase. You can trade with market, limit and stop-loss orders. They can be bought on margin, optioned and sold short.

About The Index

You're familiar with indexes. An index is one number calculated from a group of prices. It's used to track the movement of the group. It can also track the price of one security over time. When looking at an index, you need to be aware of the "weighting" used. This simply means how much weight each component is given.

For example, the Dow is price weighted. A \$50 stock has twice the weight as a \$25 stock. The S&P 500 is capitalization weighted. You take the stock price and multiply it by the number of shares. The stock of a \$500 million dollar company has twice the weight of the stock of a \$250 million company.

ETFs follow an index. "Spiders" (SPDRs) follow the S&P 500. "Diamonds" (DIA) follow the Dow. Those are a mere two of the many indexes and ETFs.

Let's dissect the ETF a bit and learn how you can put it to work in your portfolio.

Diversification

This is perhaps the greatest advantage of ETFs... the ability to easily and economically add diversity to your portfolio.

The cost of buying individual bonds can be \$1,000, \$5,000, \$10,000 or even \$25,000. If you have a large portfolio you have the capital to diversify. Let's noodle around with some numbers, shall we?

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For this example, we'll say that you should have 8 different bonds to obtain adequate portfolio diversity you want:

4 different 15-yr Corporate bonds @ \$5,000	\$20,000
4 Treasuries (1-yr, 5-yr, 10-yr, 20-yr) @ \$5,000	<u>\$20,000</u>
	\$40,000

You've decided bonds should be 40% of your portfolio.
Therefore, your total portfolio needs to be \$100,000.

This scenario gives you some diversity. The Treasuries have very little risk. The Corporates have more risk and if one defaults, you'd take a large loss.

Can we get the same diversity – more easily – with ETFs?
Absolutely.

You can buy \$20,000 of corporate bonds or a corporate bond fund. With a fund, your risk will be decreased as there will be more than 4 bonds in the fund. And you can buy \$5,000 each of 1-yr, 5-yr, 10-yr and 20-yr Treasury ETFs. These ETFs will track those Treasury issues on a constant basis so you don't have to worry about bonds maturing and then needing to be replaced.

And if at any point you want to change your mix, simply sell the ETF shares and replace them with your new mix.

Low Expenses

We know that we can use bond mutual funds as a way to get bond exposure. But ETF fees are significantly lower.

The average actively managed bond mutual fund fee according to Morningstar is 1.11%. The average expense ratio of ETFs is 0.43%... a .68% advantage. You may be inclined to dismiss that as insignificant. Don't.

Let's say your return before fees is 4%.

With a mutual fund, you'd have a net return of 2.89%. An ETF would boost that return up to 3.57%... 23% better. And let's not forget about the power of compounding.

You do pay a brokerage fee to trade ETFs just as you do to trade stocks. But there are no sales loads or distribution fees.

Additionally, ETF management expenses tend to be lower because they are passively managed. They follow an established index. This cuts down on the costs of market analysts and fund managers and other premium expenses.

And ETFs keep minimal cash on hand. With an ETF, you're trading shares of a basket of underlying assets. Any buying and selling of shares has no impact on the underlying assets.

With a mutual fund, you're giving a fund manager money to manage. The fund can grow and shrink daily. The fund manager has to put new funds to work when they come in and has to sell assets to meet redemption requests. This increases the amount of trading and the expenses that go with it, and can increase your capital gains liability.

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Transparency

With mutual funds you're not truly sure what's in the fund on any given day. After all, in an actively managed fund, you're paying for their stock or bond picking ability. If they were to make that public, there would be little reason to be in the fund.

ETFs are passively managed. You can get the list of their holdings and weightings on any given day. While that means you could replicate the fund, the advantage to you is that it's much easier and more cost effective to buy the ETF.

ETFs don't drift away from the stated objective of the fund; whereas, analysis of mutual fund holdings consistently reveals many of the holdings are not in line with the fund objective. With mutual funds you may be taking more risk than you're aware of.

Fixed Income ETFs

In the fixed income ETFs market, there are Treasury, Government and Corporate Bond products.

When you buy a bond, you have a specific maturity date. With ETFs there is no maturity date. Yes, the bonds held by the ETF have a maturity date. But the ETF regularly buys and sells bonds so that yield and maturity of the portfolio closely mimics that of the index it follows.

Exchange Traded Funds (ETFs) can give you the power of adding fixed income diversification to your portfolio with the cost and simplicity of trading stocks.

(June 2007)

Dow Jones Industrial Average- a price-weighted average of 30 actively traded Blue-Chip Stocks.

S & P 500 Index- The S & P 500 Index is the Standard & Poor's composite index of 500 stocks, a widely recognized, unmanaged index of common stock prices.

An investment in ETFs involves risk, including loss of principal. Diversification does not eliminate the risk of experiencing investment losses. By investing in high yield bonds you may be subjected to greater price volatility based on fluctuation in issuer and credit quality. When investing in bonds, you are subject, but not limited to, the same interest rate, inflation and credit risks associated with the underlying bonds owned by the ETF.

ETFs are subject to trading risks similar to those of stocks including those regarding short-selling and margin account maintenance.

Ameristock ETFs are subject to increased risk associated with investing in a specific sector compared to a more diversified investment.

There is no assurance the investment process will consistently lead to successful investing.

Ordinary brokerage commissions apply. Unlike many investments, the Funds do not try to 'beat' the markets or indexes they track, but rather match their appropriate index.

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Funds distributed by ALPS Distributors, Inc.

An investor should consider the investment objectives, risks, charges and expenses of the ETF carefully before investing.

To obtain a prospectus containing this and other information, please call 800-394-5064. Please read the prospectus carefully before investing.